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A EUROPEAN SYSTEM OF CENTRAL BANKS: OBSERVATIONS FROM ABROAD

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A European System of Central Banks: Observations From Abroad

The European Economic Community (EEC), hoping to strengthen the economic benefits of the Single-Market Initiative, seems headed toward monetary union as outlined in the Delors Commission's report. That route would eventually establish a European System of Central Banks (ESCB) with powers to conduct a common monetary policy and, presumably, to issue a single European currency.

Throughout history, nations have devised many institutions to carry out these same tasks, often relying primarily on the private sector and market discipline, and giving governments a minimal role. Today, central banks, functioning as extensions of governments and issuing fiat currencies, attempt to ensure monetary stability. Moreover, we have come to call upon central banks to perform many operations that extend well beyond the traditional definition of providing monetary stability. The record of central banks on monetary stability leaves much to be desired. The fact that central banks have not provided a stable price level over prolonged periods of time should be foremost in the minds of those charged with the formation of a European monetary union.

Today, in the context of comments on the Delors Report, I will describe those institutional attributes that, in theory, infuse central banks with their social worth. I will make the case that price stability should be the primary objective of a central bank and propose a structure to achieve that objective. I will also point out some pitfalls to avoid should you establish a European System of Central Banks.

Economic Benefits of a Monetary Union

Benefits of the economic unification of Europe will accrue primarily from the removal of artificial restraints on the movement of goods, services, labor, and capital. The gains from trade, as resources seek their most efficient use, will occur with or without the establishment of a common monetary policy or the existence of a single currency. In the last century, the various German states achieved substantial economic gains from the Zollverein (customs union) before they achieved political and monetary union. Nevertheless, with appropriate safeguards, a monetary union can augment the benefits of a single market.

Discussions of monetary union often emphasize the gains that could result from eliminating the exchange risks and currency-conversion costs associated with intra-European trade. In reality, however, these costs are relatively small and unimportant. Any benefits from European monetary union will result most directly from the ability to strengthen money as a medium of exchange, as a temporary store of value, and as a unit of account. Acting in these capacities, money reduces the information and transaction costs associated with commerce, thereby allowing for better decisions, longer-term contracts, and improved productivity.

As German business people know so well, the economic efficiencies of money depend first and foremost on the stability of its purchasing power. Issuers of money must forge a trust with those who hold that money or denominate their wealth in it. When that trust is eroded, individuals and businesses devise elaborate and expensive schemes to minimize their cash holdings and to protect their wealth. Such unproductive uses of resources necessarily lessen the economic benefits afforded from the use of money. Should the trust between issuers and holders of money collapse completely, so too will the functions of money, and trade will revert to barter.

The Primary Objective of a Central Bank: Price Stability

The primary role of a central bank is to provide an immutable guarantee of the long-term stability of the purchasing power of money. In this way, a central bank maximizes the efficiencies that money affords and creates an environment conducive to sustained growth in the standard of living. Countries with relatively low, stable rates of inflation seem to experience relatively faster rates of real economic growth.[1] Price stability not only eliminates the need to hedge against inflation, but it removes an important source of uncertainty associated with making long-term contracts and committing to long-term investments. Price stability also cements the social contract whereby governments do not impose taxes on wealth without the consent of their citizens.[2] The uncertainty and hidden taxes that inflation generates reduce long-term investments, which have proven vital to technological advances and sustained real economic growth.

The prominence given to price stability in nearly all proposals for a European central bank is heartening. The Delors report recommends that price stability be the primary objective of the ESCB and encourages the central bank to support other Community economic policies and exchange-rate stabilization only when price stability is not compromised.

In recommending this approach, the Delors Commission is following the German example of central banking. The Deutsche Bundesbank Act specifies that the primary function of the Bundesbank is to "safeguard the currency." The Act also requires the Bundesbank to support the economic policies of the Federal Government, but only "without prejudicing" its primary function.[3] Nevertheless, I am concerned that in some subtle -- yet important -- respects, the Bundesbank model is not strictly appropriate for the ESCB.

Terms such as "safeguarding the currency," "monetary stability," or "price stability" are ambiguous. In common usage, for example, price stability has at least three interpretations. To some individuals, it implies that prices can rise, but not to such an extent that inflation affects private decisions. Others interpret price stability as an expected zero-inflation rate, but see no need to offset actual jumps in the price index. Accordingly, the price index can drift up or down. A third interpretation of price stability requires the central bank to offset any deviations in the price level from its baseline value.

The Bundesbank views its principal directive, "safeguarding the currency," as a mandate for price stability in the sense of not allowing inflation to affect private decisions. More important, the Bundesbank interprets this directive very narrowly in its operations, exhibiting a general distaste for inflation exceeding 2 or 2.5 percent per year. Consistent with its legal mandate, the Bundesbank does at times pursue other policy objectives, notably exchange-rate stabilization. Yet, the Bundesbank has maintained its credibility in pursuing price stability. Credibility is important because it reduces the real economic costs of maintaining price stability in the face of random economic shocks or policy errors that periodically buffet price indexes.

As the Delors Commission undoubtedly realizes, the Deutsche Bundesbank Act provides the Bundesbank with a foundation for its credibility. But more important, through years of steadfastly interpreting its primary directive narrowly, the Bundesbank has built a strong reputation for consistently pursuing low inflation. This reputation has strengthened a rather vaguely stated official objective. No other central bank enjoys a similar level of credibility for price stability.

The ESCB, initially, will lack such a reputation. Because reputations are slow to build and quick to vanish, many economists recommend that central banks adopt rules for price stability that are verifiable, unambiguous, and enforceable. I have long advocated such a rule for the Federal Reserve System, and I would encourage the European Community to adopt a similar price-stability directive.

I have suggested that the Federal Reserve System adopt a stable price level as the sole target for monetary policy. When prices deviate from the baseline level, the System must act to bring prices back in line.[4] I also support Congressional legislation to underscore the importance of price-level targeting. Such a system would be easy to monitor and the legislature could easily hold the central bank accountable for attaining the directive.

An Institutional Structure to Achieve the Price-Stability Objective

To secure a goal of price stability for the ESCB, the European Community must craft an institutional structure to carry out that task. The structure must offer no leeway for political maneuvering, which ultimately would undermine the central bank's pledge of price stability.

A perennial issue in the debates about central banking -- one especially germane to the establishment of the ESCB -- is how to balance central-bank independence from political pressures, and central-bank accountability to the public. The Delors Commission, wisely choosing the Bundesbank as a model, recommended that the ESCB be independent of European fiscal authorities, but nevertheless noted the need to make the central bank accountable to the "democratic process."

Independence: Countries that afford their central banks a high degree of independence typically have experienced lower rates of inflation.[5] The basic requirements to ensure central-bank independence are that the central bank have no obligation to purchase the debt of any fiscal authority, and that the respective finance ministers be excluded from voting on monetary policy. Nevertheless, concern remains because most European central banks presently assist in financing their governments' fiscal budgets. Many, for example, pre-finance their governments' budgets, by buying and re-selling the debt. Even the Bundesbank can grant temporary short-term credit to the government. The ESCB must remain free of all hints of fiscal assistance if it hopes to establish credibility for price stability.

Although buying government debt is the most direct and obvious linkage between central banks and fiscal authorities, indirect channels of influence also exist. The structure of the Federal Reserve System attempts to minimize these indirect connections between the power to create money and the ability to spend public funds. For example, the Federal Reserve System is self-financing. The System generates its own revenues, pays its own bills, and remits its profits to the U.S. Treasury. The Federal Reserve System is not subject to the appropriations process of the U.S. Congress, since this could prove to be a conduit for political pressures.

The governance structure of a central bank can also affect its susceptibility to political influence. Within the Federal Reserve System, the Federal Open Market Committee (FOMC) decides monetary policy by a majority vote of the seven governors and the five voting District Bank presidents.[6] The President of the United States, with Senate confirmation, appoints the seven governors of the Federal Reserve Board. To minimize the potential for political influence, the Federal Reserve Act stipulates that governors serve a single 14-year term.[7] Each District Bank's board of directors, with the approval of the Board of Governors, appoints a president of that regional Reserve Bank. The District-Bank directors represent banking and other public interests in each district. Commercial banks elect most of the directors, and the Board of Governors chooses the remainder. This dispersion of power among different individuals who have come to the central bank through different paths, and with different allegiances, helps to reduce the concentration of political interests and to lessen the impact of external political influences on the central bank.

An analysis of the voting record by Federal Reserve Bank presidents and governors highlights the importance of a decentralized structure for a central bank. Over the past 25 years, as our price index rose nearly fourfold, presidents were twice as likely as governors to dissent from the FOMC's majority in favor of a tighter monetary policy, while governors were five times as likely as presidents to dissent from the majority in favor of an easier monetary policy.[8]

Although Germany has a central bank with a similar decentralized structure, nearly all other European nations seem to favor a more centralized arrangement. As the European Community considers the governance structure of the ESCB, it should be careful not to adopt a structure that could compromise the price stability objective.

Accountability: While supporting the independence of the ESCB, the Delors report stresses a need to make the central bank accountable to the "democratic process." Central banks are products of governments and as such are naturally accountable to the governmental entities that create them. This accountability can provide a useful support for central banks, or it can become a serious impediment to their proper functioning. The outcome depends on how a nation or a group of nations frames central-bank accountability.

When a nation does not assess central bank performance in terms of an unambiguous, verifiable goal, such as price stability, accountability is a detriment to the smooth functioning of a central bank and becomes an avenue for political influence. The Federal Reserve System offers an example. The United States Congress created the System and retains the power to alter its form and function. Congress requires the System "...to promote effectively the goals of maximum employment, price stability, and moderate long-term interest rates." However, Congress allows the System discretion in how best to pursue these goals.

With multiple goals and no overall ranking of System objectives, the criterion for success -- the measure of accountability -- is ambiguous and subject to change. Priorities will shift as political and economic circumstances alter the implicit weights that elected officials assign to specific objectives. Being ultimately responsible to Congress, the Federal Reserve System has an incentive to alter the weights that it gives to various goals. This provides monetary-policy decisions with a myopic focus. Fashioned in this manner, accountability becomes the antithesis of independence.

When, instead, legislatures measure accountability in terms of an operationally unambiguous and technically achievable goal, accountability effectively complements central-bank independence by giving the central bank a single, long-term focus. Self-imposed monetary rules can lack force and credibility with the public because a believable enforcement mechanism does not exist. Consider this issue for a moment. Has a central-bank policy committee ever dismissed itself for generating inflation, or for consistently missing a monetary target? When a superior legislative body, which is responsive to the public, imposes the rules on a central bank, those rules are more likely to be enforced and are more credible. For this reason, I, along with a number of other Federal Reserve officials, have supported Congressional legislation in the United States mandating price stability as the Federal Reserve's primary goal.

Pitfalls to Avoid

Although most legislatures acknowledge the importance of preventing inflation, none specify price stability as the sole business of central banks and few even accord it top priority. The Delors report envisions the ESCB undertaking other economic functions, notably exchange-rate stability. I object to such contingency plans on two counts: First, they create doubts about a central bank's willingness and ability to pursue its primary objective. Second, these contingencies are often technically infeasible and of dubious economic merit.

Foreign-Exchange Intervention: The Delors report, for example, would instruct the ESCB to smooth ECU (European Currency Unit) exchange-rate movements. Research indicates that central banks cannot conduct intervention separate from monetary policy. Focusing monetary policy on an exchange rate is, at times, consistent with price stability, such as when a central bank acts to prevent an inflation-induced depreciation of its currency. Just as easily, however, intervention can be inconsistent with price stability. Then, intervention raises doubts about the central bank's commitment to pursue a stable price level. If traders expect policy to switch between price and exchange-rate objectives, they will continue to hedge against inflation and exchange risk, creating uncertainty and costs. Intervention then reduces the efficiency of money.

Inflation-Unemployment Trade-off: Similarly, many legislators on both sides of the Atlantic believe that central banks should attempt to exploit possible short-term trade-offs between inflation and unemployment in an attempt to stabilize the business cycle. I disagree with such attempts. Besides jeopardizing credibility, such attempts are not systematically feasible. Money stock changes can temporarily alter employment and output only if these changes confuse individuals about the nature of price movements or if market frictions prevent individuals from adjusting prices quickly. In either case, there is no stable trade-off between real economic activity and inflation. As markets anticipate the resulting inflation, more and more inflation is built into the economy, quite independent of the phase of the business cycle. U.S. inflation immediately after the last recession was roughly as high as it was at the business-cycle peak in the late 1960s.

Financing Debt: The ESCB could face a unique challenge to price stability because of the ability of national governments in the European Community to issue debt. Because many European nations are large relative to credit markets, with monetary union the debt of some individual nations could raise interest rates throughout the Community. Pressures on the central bank to avoid high interest rates could result in the ESCB inadvertently financing the borrowing of individual member countries. Some European countries have fiscal policies that seem unsustainable. Other nations support various inefficient industries. With the power to create money no longer vested at the national level, some countries could experience difficulties in placing debt. This further highlights the need for a price-level target.

Financial Panic: Questions also arise concerning the role of the ESCB should a government or a state-run enterprise default on its obligations. Major defaults, stock market crashes, and other shocks occasionally buffet the economy, producing financial panics.[9] A financial panic can slow money growth dramatically and place strong downward pressure on prices. In such cases, an increase in the monetary base is consistent with an objective of price stability.

Financial panics are especially precarious because, in confronting them, a central bank must stabilize the price level without providing bailouts to specific institutions or groups of institutions. Should it fail, the public will come to view the central bank as a political institution and will question its commitment to price stability.

To avoid the perception of political expedience, the central bank must approach the task in a manner that emphasizes its macroeconomic aspects, rather than its lender-of-last-resort character. The general objective is to provide a temporary injection of liquidity without attempting to prop up insolvent firms or even giving such a perception. Supplying liquidity exclusively through open-market operations not only avoids loans to specific institutions, but is also more efficient. Offering loans to individual banks, especially institutions that are approaching insolvency, creates a moral hazard problem that, in the long run, can increase the frequency of financial crises. Lending, and the associated moral hazard problems, requires the central bank to spend substantial resources on the supervision and regulation of the financial community.

Implicit in a macroeconomic approach to financial crisis is a willingness to allow individual institutions, even large ones, to fail. Discount-window lending, particularly at, or below, market rates, can easily become a subsidy to firms that do not meet the market test. If the European Economic Community is unable to allow certain firms to fail, it should remove the bailout function from the central bank and vest that responsibility in an independent agency that is directly responsible to the European Council and European Parliament. The European Parliament should fund the bailouts through direct budgetary appropriations. Such an arrangement would ensure direct political accountability for the bailouts, while preserving the monetary integrity of the central bank.

Conclusion: Monopoly or Competition?

The Delors Commission seeks to grant the ESCB a European monopoly for the issuance of fiat money. I have suggested four general criteria to ensure that this institution produces an efficient product: first, unambiguously establish price stability as the sole objective of the central bank; second, make any government-sponsored central bank completely independent from fiscal authorities; third, hold the central bank accountable to a legislative body (i.e., the Parliament) solely for attainment of a stable-price rule; and fourth, address any financial crisis that threatens price stability only through open-market operations.

The Delors report, using the Deutsche Bundesbank as a model, endorses most of these recommendations. However, beyond Germany, few European nations appreciate the dangers of mingling the power to spend with the power to issue fiat currency. I find it difficult to accept the argument that governments, which individually resort to the inflation tax, will collectively choose to avoid that revenue source, particularly in an arrangement that lessens the dominance of the Bundesbank. Today, Germany's low-inflation monetary policy provides a price anchor to countries participating in the Exchange-Rate Mechanism. An ESCB structure that dilutes Germany's influence without establishing a clear, mandatory price-level target, will almost certainly make Germany worse off.

If the EEC cannot adopt a legal commitment to price stability along the lines that I have suggested here, Germany might not wish to grant the EEC a monopoly in this area. Instead, Germany might foster a monetary-policy competition by strengthening sanctions against countries that might attempt to reimpose barriers to the free movement of capital and real resources.

The resource movements associated with the Single-Market Initiative will confer great benefits on the European Economic Community. They will create natural competition for sound government policies, and the movements of resources across borders will effectively register votes on policy. Governments that institute excessive rates of taxation, through inflation or more explicit means, will see their tax bases shrink. This competition will foster, indeed encourage, coordination of monetary and fiscal policies even without the establishment of a single European central bank. This competition either will produce an evolutionary convergence of inflationary preferences among the European states, thereby completing the groundwork for monetary union, or it will graphically illustrate the impossibility of forcing monetary union on countries with different inflation preferences.

FOOTNOTES

1 See William T. Gavin, "In Defense of Zero Inflation," Federal Reserve Bank of Cleveland Working Paper 9005 (June 1990), for discussion and references to evidence.

2 See David Altig and Charles T. Carlstrom, "Inflation and the Personal Tax Code: Assessing Indexation," Federal Reserve Bank of Cleveland Working Paper 9006 (July 1990).

3 This English translation of the Deutsche Bundesbank Act is found in The Deutsche Bundesbank, Its Monetary Policy Instruments and Functions, Deutsche Bundesbank Special Series No.7 (October 1982).

4 A 2 percent band around the target level would be acceptable provided that the target is an unchanging price level.

5 See "Central Bank Independence," Federal Reserve Bank of Cleveland, Annual Report 1989 for a discussion and references to evidence.

6 All twelve district bank Presidents attend the FOMC and participate in its deliberations, but only five of the twelve vote at any particular time.

7 Some appointments, however, fill out vacancies left in existing terms.

8 "Central Bank Independence," Federal Reserve Bank of Cleveland, Annual Report 1989, footnote 3, page 18.

9 A price level target could eliminate a historic source of such shocks: abrupt shifts in monetary policy.